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ONE HUNDRED SEVENTH CONGRESS

**U.S. House of Representatives**  
**Committee on Energy and Commerce**  
**Washington, DC 20515-6115**

W.J. "BILLY" TAUZIN, LOUISIANA,  
CHAIRMAN

January 30, 2002

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DAVID V. MARVENTANO, STAFF DIRECTOR

The Honorable Harvey L. Pitt  
Chairman  
Securities and Exchange Commission  
450 5<sup>th</sup> Street, N.W.  
Washington, D.C. 20549

Dear Chairman Pitt:

We are writing to express our concerns about the potential adverse impact for mutual fund investors of Section 125<sup>1</sup> of H.R. 3406, the "Electric Supply and Transmission Act," and to request the Commission's views and analysis of this provision.

According to recent press reports, during Congressional consideration of the National Securities Markets Improvement Act of 1996 (Public Law 104-290), the Enron Corporation sought to obtain an exemption from having to register under the Investment Company Act of

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<sup>1</sup> Section 125 reads as follows:

SEC. 125. EFFECT ON INVESTMENT COMPANY ACT REGULATION.

(a) GRANDFATHER OF EXISTING HOLDINGS- A person that, on December 31, 2001--

(1) was an affiliate of a holding company, and

(2) held investment securities of one or more companies engaged directly or indirectly in the electric or gas utility business, or other permitted business activities for a registered holding company and its subsidiaries,

shall not be treated as being an investment company under section 3(a)(1)(C) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)(1)(C)) on the basis of investing, reinvesting, owning, holding, or trading any investment securities issued by companies in which such person held such investment securities as of such date.

(b) DEFINITIONS- As used in subsection (a):

(1) HOLDING COMPANY- The term 'holding company' has the meaning provided in section 2(a)(7) of the Public Utilities Holding Company Act of 1935 (15 U.S.C. 79b(a)(7)).

(2) AFFILIATE- The term 'affiliate' has the meaning provided in section 2(a)(11) of such Act (15 U.S.C. 79b(a)(11)).

(3) INVESTMENT SECURITIES- The term 'investment securities' has the meaning provided in section 3(a)(2) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)(2)).

1940.<sup>2</sup> When the Congress rejected Enron's efforts to obtain such an exemption, Enron reportedly obtained an administrative exemption from the Act from the SEC staff. Former SEC Chairman Arthur Levitt told the New York Times in the cited article that the granting of this exemption "may be one of those cases of the nail in the shoe of the horse. It may be one of those things that seemed insignificant at the time but can wind up being determinative." Another former SEC official was more critical: "This was a case of giving Enron an inch and they took miles. They were given a significant new opportunity, and they took it and flew it smasho into the ground."

In light of what Enron was able to do with the administrative exemption granted it by the SEC staff in 1997, we are extremely wary of granting the exemption proposed in Section 125 of H.R. 3406.

The intent of Section 125 is unclear. Curiously, there is no reference to this particular provision in the summary of H.R. 3406 posted on Representative Barton's Web site (<http://www.house.gov/barton/3406summary.html>), the detailed section-by-section analysis of the bill (<http://www.house.gov/barton/3406sectionbysection.html>), or the summary of changes made to an earlier discussion draft of the bill circulated prior to its introduction (<http://www.house.gov/barton/3406changes.html>). We recall no testimony on this matter at our hearings.

Our concern about this provision is very simple. While the heading for this section is an innocuous-sounding "Grandfather of Existing Holdings," it appears to create potentially dangerous loopholes in the system of investor protection that has enabled the mutual fund industry to grow successfully and largely scandal-free over the last 60 years. Read literally, the provision appears to state that any company that was, as of December 31, 2001, an affiliate of a holding company (as defined under the Public Utility Holding Company Act of 1935 or "PUHCA") and held investment securities (as defined under the Investment Company Act of 1940) of one or more companies engaged directly or indirectly in the electric or gas utility business, or other permitted business activities for a PUHCA registered company or its subsidiaries (which have expanded in recent years to include investments in foreign utilities, out-of-region generation companies, telecommunications companies, and other types of companies) shall not be treated as being an investment company. As a consequence, the provision appears to establish that, as of December 31, 2001, a number of existing investment companies will not be viewed as investment companies in the future based solely on certain holdings as of a date certain, regardless of the future business activities of such companies.

Under this provision, it appears to us that a registered holding company could sell a company that was an affiliate on December 31, 2001, to a third party that could use it to operate an investment company that would compete directly with registered investment companies. This unregulated "grandfathered" investment company would not be required to actually register with

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<sup>2</sup> See Stephen Labaton, "Exemption Won in '97 Set Stage for Enron Woes," The New York Times, January 23, 2002, Page A1.

the Commission as an investment company and would not be subject to the same regulatory framework as other investment companies.

Alternatively, a PUHCA-registered holding company could use one of its subsidiaries in existence on December 31, 2001, to operate its own unregistered and unregulated investment company. Since Section 112 of H.R. 3406 effectively repeals PUHCA 12 months after the date of enactment, the diversification and investment restrictions of that Act would no longer apply to the portfolio of investments that would be permitted for such subsidiaries. It would therefore be free to invest in any securities or other investments, without any of the protections afforded by the Investment Company Act, such as oversight by independent directors, bans on affiliated transactions, daily marking-to-market of assets, limits on leveraging, and special full disclosure requirements.

Moreover, the special "grandfathered" investment companies that could be established pursuant to Section 125 would not be subject to the restrictions applicable to other investment vehicles, such as hedge funds, that currently rely on specific exemptions from registration under the 1940 Act. They could therefore engage in some of the risky and speculative investment strategies pursued by hedge funds with no assurance that they would be limited in size pursuant to statutory limits on the number of hedge fund investors, or restrictions limiting such funds to sophisticated investors.

As H.R. 3406 may be marked up in the Subcommittee on Energy and Air Quality as early as next month, we request your assistance and cooperation in providing responses to the following questions no later than close of business, Wednesday, February 13, 2002:

1. Please provide a list of all of the registered holding companies in existence as of December 31, 2001, and, for each such company, an organizational chart listing all affiliates of such registered holding company as of that date.
2. For each affiliate of each registered holding company in existence as of December 31, 2001, please indicate whether it is wholly or partially controlled by the registered holding company. For all partially-controlled affiliates, please provide a list of all other principal holders of equity or debt securities issued by the affiliate.
3. For each affiliate of a registered holding company in existence as of December 31, 2001, please provide a list of the officers and directors of the affiliate, and a summary of the principal businesses of the affiliate.
4. For each affiliate of each registered holding company in existence as of December 31, 2001, please provide a list of all the securities held by such companies on that date (including all equity, debt, exempt or other securities of any type), including the name of the issuer of such shares, the number of shares held by the affiliate, and the market value of such shares as of December 31, 2001.


The Honorable Harvey L. Pitt

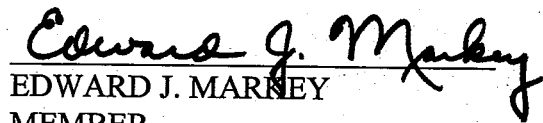
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5. In light of the information provided in your responses to the previous questions, please indicate how many unregulated investment companies potentially would be permitted to exist if proposed Section 125 became law, and what securities such companies would be permitted to invest in.
6. Please provide us with the Commission's views regarding the impact of proposed Section 125 of H.R. 3406 on the SEC's ability to adequately regulate investment companies. In your response, please address the concerns that we have raised about the potential for this provision to result in the emergence of unregulated mutual funds, as well as your views on whether investors in such funds are deserving of the investor protections afforded by the Investment Company Act of 1940 and, if not, why not.
7. Please provide us with copies of all notes, memoranda, e-mails, letters, or other documents, which relate in any way to the exemption granted to Enron in 1997 from the Investment Company Act of 1940.
8. If the SEC had not granted this exemption for Enron, what impact would registration under the Investment Company Act have had upon Enron's subsequent foreign investments? Is it possible that some of the potentially fraudulent actions subsequently undertaken by Enron might have been prevented?

Thank you for your assistance and cooperation in this matter. Should you have any questions about this request, please contact us or have your staff contact either Consuela Washington (202-225-3641) or Sue Sheridan (202-226-3400) of the Committee on Energy and Commerce Democratic staff, or Jeffrey Duncan (202-225-2836) on Representative Markey's staff.

Sincerely,

  
JOHN D. DINGELL  
RANKING MEMBER

  
EDWARD J. MARKEY  
MEMBER

Enclosures

cc: The Honorable W. J. "Billy" Tauzin, Chairman  
Committee on Energy and Commerce

The Honorable Joe Barton, Chairman  
Subcommittee on Energy and Air Quality

The Honorable Rick Boucher, Ranking Member  
Subcommittee on Energy and Air Quality